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Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

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A Time for Reason

"The only thing we have to fear is fear itself."
—Franklin Delano Roosevelt (First Inaugural Address)

Throughout history there have been times when a unique conjunction of events has led to deep uneasiness and, on a number of occasions, to widespread proclamations of crisis. The past few months might give one the impression that we are passing through such a period. A few large banks incur quarterly losses and rumors circulate that a number of large banks are "in trouble." A few developing countries find that they must reschedule their debt and rumors circulate that the entire international financial structure is coming apart at the seams. Unemployment and business failures increase as economic growth is halted in the important developed countries because they are getting control over their domestic inflation and the financial press reports that the world is set on a course that will soon lead to world-wide depression.

In a setting where economic growth has been absent for a number of years and where governments appear to be pursuing policies that do not give encouragement as to its early revival, rumors dealing with the soundness of the international financial structure in general and the banks in particular can easily get started. Traders of funds and securities are in touch with each other constantly and must react instantly to every news item—whatever its ultimate veracity. The financial press, ever-hungry for new developments to report, many times tends to elevate rumors to the point where they are accepted as the gospel, in effect turning hearsay into self-fulfilling prophecy. How valid are these rumors and fears?

Even a Candide could not blind himself to the existence of some economic and financial problems in the U.S. and elsewhere. Nearly four years of essentially no economic growth have produced jobless rates here not seen in over forty years and rates of business failures not seen since the early 1930s. Entire regions and whole industries are experiencing depression-like conditions. Since the U.S. bulks so large in world markets, our stagnant economy has affected many others. To prevent an even deeper plunge in the value of their currencies against the U.S. dollar than that which has already occurred, many countries have been forced to maintain high interest rates, which, in turn, has squeezed down their economies. Another depressant is the lower level of exports to the U.S. from developed as well as less developed countries because of our reduced demand. Finally, the much slower pace of inflation has cut into the ability of many countries—particularly the developing countries which tend to be commodity exporters—to generate enough foreign exchange to cover their imports and pay their bills.

The Roots Of The Problem

Like so many "crises," the current situation did not appear overnight. Rather, it is the culmination of a series of developments stretching back nearly ten years. At that time, most of the world's currencies were set free from their moorings to float against one another. During the first two years of generalized floating, 1973 and 1974, day-to-day changes in the relationship of currency values to one another were unusually large—sometimes as much as two per cent in a single day. While several financial institutions incurred losses in their foreign exchange trading as a result of not being able to cope correctly with this new environment, it should be noted that world trade did not collapse with the fall of Bretton Woods. Quite the contrary, despite the advent of floating exchange rates—which some feared would lead to a contraction of world trade—multilateral commerce expanded. In 1970, before currencies were free to float, only one-eighth of total world output was traded internationally. Ten years later, that share had increased to nearly one-quarter.

The arrival of the floating exchange rate "system" came none too soon. For beginning in late 1973, international oil prices took a quantum leap upward, causing the oil exporting countries to develop massive foreign exchange surpluses and the oil importing countries to incur large deficits. The word "recycling"

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came into general use as shorthand for nothing less than the greatest transfer of wealth in the history of mankind — that is, channeling the surpluses of the oil-exporting countries into those importing countries with the greatest need. As you will recall, there were many at the time who said it simply could not work. The prophets of doom had a field day — and not without good reason, since there were two stumbling blocks in the way of a smooth accommodation to the circumstances. For one thing, the oil-exporting countries were initially inclined to invest the biggest portion of their revenues in assets of very short maturities. For another, the oil exporters directed their investments into those countries and currencies that promised the greatest safety for principal. Thus, large amounts flowed into the United States directly, landing mainly in Treasury bills and in the major U.S. banks.

Meanwhile, those countries that were importers of oil soon developed very large deficits. At the time, both developed and developing countries were in this position. They needed the oil money in amounts that would cover their trade deficits, and the process of obtaining these funds was handled efficiently by the private banking system. Some countries used these funds to invest in infrastructure which ultimately reduced their dependence on oil and/or generated an income stream sufficient to help pay their debts. Others, because of their less developed nature, were unable to do this and found themselves getting deeper and deeper in debt. Risk exposure began to rise in the mid-1970s leading to a greater reliance on direct government-to-government lending and recourse to such international agencies as the World Bank.

There were other by-products of this quantum leap in oil prices. For one thing, it set off a round of double-digit inflation in many countries because of the ubiquitous nature of the product. However, the unwillingness of the Federal Reserve to fully monetize the greater dollar needs associated with rising petroleum prices caused the U.S. to experience what until that time was its deepest recession in the postwar era. The much higher price of oil also had its effect on a number of key industries in the U.S. — not the least of which were automobiles and housing, two industries that had grown and prospered in an era of cheap, readily-available energy.

The 1973–75 recession took some of the steam out of the inflation that was generated by higher oil prices, but toward the end of the decade inflation began to flare up once again. In response, the Federal Reserve stopped focusing on trying to manage interest rates and began focusing on trying to manage the money supply — a policy known as monetarism. This produced a whole new set of circumstances for the banks in particular and the international financial system in general to cope with — such as domestic interest rates joining foreign exchange rates in being extremely volatile.

Monetarism soon accomplished its main objective — the slowing of inflation. From 13 per cent in 1979 (and an annual rate of nearly 20 per cent in first-quarter 1980), the rate of inflation in the U.S. slowed dramatically. By the summer of 1982, consumer prices in the U.S. were barely six percent higher than their year-ago levels — while wholesale prices were up only four per cent. Not surprisingly, this meant that prices of many items had actually fallen. Besides the widely-publicized price reductions in a number of big-ticket consumer durable goods, prices of basic commodities dropped significantly. Industrial commodities prices are now off about 25 per cent from their peaks reached 2½ years ago, while food commodities are down some 20 per cent. Many individual commodities are no higher today than levels first reached in the mid-1970s — while some are significantly below even that. This means, of course, that the income of many developing nations, which depend on exports of these commodities for their livelihoods, plunged sharply. At the same time, rapidly rising interest rates, a byproduct of earlier inflation and now the volatility of interest rates, themselves, added to these countries' debt burdens as well.

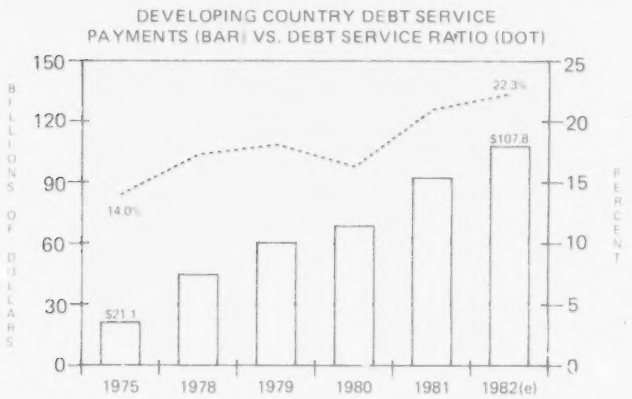
Another development germane to the current situation occurred early in 1981. Shortly after assuming office, President Reagan removed controls on crude oil prices. Soon after, world oil prices peaked and have been edging downward ever since. From a high of nearly $36 per barrel, the average price of crude oil in spot markets has since fallen below $32. At one point last spring, spot prices fell below $28 a barrel, causing a marked softening in what had been a booming industry: the search for, production, and distribution of oil. Those companies here and abroad engaged in this industry as well as those institutions which lent or invested money found themselves facing a new, undoubtedly surprising set of circumstances — as have countries of heretofore unquestioned credit rankings because of oil.

Through it all, a number of governments attempted to cope by a return to economic nationalism. Protectionism emerged under new guises; predatory financing and non-tariff barriers became the order of the day. There has been a decline in economic and monetary cooperation among the major nations of the world, in sharp contrast to the spirit of partnership that was the centerpiece of policy in much of the postwar period. But while governments increasingly have gone their own way, the world of international finance has become even more functionally integrated with the result that there is a growing disparity between how the world works and how governments govern. Some of the so-called "problem loans" confronting major

banks today are the result of initiatives taken in Washington and elsewhere that in effect have made private banks and international markets the cutting edge of foreign policy.

Rescheduling Is Nothing New

The fact that there is a logical explanation for all of this in no way, of course, minimizes whatever problems exist today in the international financial system. So let me turn to the problems, themselves, to see if they are as bad as they appear. Take rescheduling, for example. To read the plethora of articles in the financial press, one would think that rescheduling of previously incurred debt either by companies or



sovereign governments is something new. It is not. Bankers for centuries have worked with their customers — large and small — whenever it was apparent that the repayment of debt was becoming a problem. Internationally, rescheduling has been a fact of worldwide banking to sovereign governments — especially during the past quarter of a century. In fact, there have been 53 sovereign debt reschedulings since 1956 — proof that rescheduling can work! In the U.S., Washington "reschedules" its debt all the time — only here it is called "rolling over." According to the Treasury, the U.S. rolls over about $11 billion of debt in its weekly Treasury bill auctions. The U.S. government has not paid *down* — much less paid *off* — its debt on an annual basis since 1969, the last time it ran a surplus in its budget.

Having said this, I must admit that a number of differences exist today compared with the past. For one thing, the process of financing oil-bloated payments deficits has stretched the capacity of many sovereign borrowers to service it. Although the chart shows an aggregate debt service ratio for the non-oil developing countries at a relatively comfortable point, some countries undoubtedly are at levels where it is becoming difficult to take care of their domestic needs while servicing their external debts. Here at home, the 50-year high level of business bankruptcies has taken its toll among companies large enough to have made the headlines with the debts they owe their bankers. In some cases the debts were rescheduled and the company involved returned to a viable state of health. In other cases the banks had to take a charge against earnings. The point is — bankers reschedule only when they believe that the problem can be resolved.

Let us look at the ability of the banks to withstand such chargeoffs domestically as well as what the implications of reschedulings to sovereign governments might mean. Because loan chargeoffs are up, banks have increased their provisions for possible future loan losses in order that total loan loss reserves be maintained at an adequate level. But in spite of this bank earnings are still healthy. Thus even if there is a need to charge off additional loans made to private corporations, the banks are well able to withstand this. As for loans to nations, with the exception of Cuba, no American bank in the postwar era has lost a penny on loans to sovereign governments. For whenever a sovereign government attempted to repudiate its international debt, it was faced with having to do without the system within which it had operated.

Needless to say, the current situation is not one that we can be unconcerned about. Rather, it should — and can — be ameliorated. We may never eliminate the need for normal reschedulings because the need to adjust banking arrangements to meet the changing circumstances of borrowers is something that has always been with us, whatever name we give it. And, it should be remembered that the banks do provide the mechanism for accommodating economic imbalances in an uneven world — imbalances which, at times, may temporarily strain this mechanism, but not break it. That is, after all, the role of banks in economic systems. Nevertheless, today's high rates of joblessness and business failures demand that anything that can be done to moderate these circumstances should be.

Some Possible Solutions

I have several suggestions. For one thing, an America back on course will have many salutory effects on the rest of the world. If we could begin growing again, our domestic corporations would generate the cash flow necessary to help pay their debts, while our trading partners would find markets more receptive to their goods — especially those raw materials now languishing for lack of demand. Lower interest rates would help both private corporations and sovereign governments bear the burden of debt. All of this can come about if Washington does some restructuring of its own — its economic policy. I speak of a more restrictive fiscal policy linked with a more accommodative monetary policy.

Inflation may not have been wiped out, but with some 30 per cent of our industrial capacity lying idle, nearly

11 million people out of work, and commodities prices well below their recent peaks, inflation does not seem likely to revive quickly if the monetary authorities were to be a little more generous in providing money to the system. On the fiscal side, the government must turn away from benign neglect of deficits and realize that they *do* matter. The true burden of government is reduced, not just by cutting taxes, but by lowering spending as well. If taxes are reduced and spending is not, the burden is just as onerous as it was before, if not more so.

A worldwide recovery will help firm up most commodities prices — especially relative to oil prices. This must happen, if the non-oil developing countries are to once again pay their own way in world trading markets. You cannot lift such an important commodity as oil out of the giant matrix of commodities worldwide, increase its price manyfold in a short period of time, and not expect to see adverse effects in a variety of areas.

Finally, it must be recognized that the banks always have and always will help those customers of theirs — be they individuals, private corporations or sovereign governments — who find themselves temporarily illiquid, but not insolvent. In particular, the process of rescheduling sovereign debt will be aided by a recognition that governments have a larger role to play in development finance. This Bank has already endorsed the Administration's call for a greater amount of co-financings between the World Bank and private lenders. Foreign aid may be out of fashion these days, along with stepped-up funding for the IMF, the World Bank, and its affiliate, the IDA. But all are essential in addressing the urgency and magnitude of development financing requirements. Along with these official sources, of course, there is a role for private institutions, sometimes acting alone and sometimes in concert with official agencies. But this is no time to be diminishing the resources of official agencies in the expectation that private sources can fill the gap. Governments of developing countries will need a level of help that goes beyond the capacity of private sources.

Nevertheless, the growth and size of developing country debt should not be exaggerated. As the chart on page three also shows, a five-fold increase in developing country debt service payments between 1975 and 1982 led to only an 8.3 percentage point rise in their aggregate debt service ratio. This means that their gross national products as well as their exports of goods and services rose, too — although obviously not as rapidly. Debt service was also bloated by its concentration in short maturities, whose interest rates rose with the general rate structure.

The underlying economic and financial circumstances today do not justify the atmosphere of alarm that the media appear to be generating. Past economic crises, including the Great Depression, would not have happened based on economic circumstances alone. They were created by waves of fears and rumors that helped bring about the feared results. Responsible policies by governments, industrial concerns, financial institutions—and the media—can and will avoid the extreme dangers that are now so much on everyone's mind.